

April 4, 2011

Alert

SEC Disclosure and Corporate Governance

Dodd-Frank Act Update: SEC Proposes Rules Regarding Compensation Committees and Their Advisers

- Defers to Exchanges to Develop Standards
- Also Proposes Disclosure Changes

On March 30, 2011, the U.S. Securities and Exchange Commission proposed listing standards and disclosure rules to implement Section 952 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. The proposed rules are available at <http://www.sec.gov/rules/proposed/2011/33-9199.pdf>.¹

In seeking to implement the Dodd-Frank Act, the SEC did not take a prescriptive approach but instead deferred to the exchanges to develop (within the Dodd-Frank parameters) their own standards for compensation committee independence and other required matters. The SEC's approval will be required before the listing standards become effective.

The proposed rules:

- Direct the stock exchanges to develop a standard for determining the independence of compensation committee members.
 - While they require the exchanges to consider certain factors, the proposed rules do *not* mandate any specific independence criteria or *per se* bars.
- Direct the stock exchanges to develop factors bearing on the independence of consultants and other advisers that compensation committees will be required to consider prior to engaging these advisers.
 - The proposed rules do *not*, however, mandate that the exchanges require that compensation consultants and other advisers be independent.
- Direct the stock exchanges to require that compensation committees have the authority and discretion to retain or obtain the advice of consultants and other advisers, and that companies provide appropriate funding for these advisers.
- Amend current disclosure rules regarding the retention of compensation consultants and their conflicts of interest to harmonize with similar disclosure requirements of the Dodd-Frank Act.

Framework

Section 10C of the Securities Exchange Act of 1934, which the Dodd-Frank Act added, requires the SEC to adopt rules requiring the stock exchanges to prohibit the listing of any equity security of an issuer – other than a controlled company or an issuer in certain other exempt categories –

that does not comply with Section 10C's requirements regarding compensation committees and their advisers. To implement Section 10C, the SEC has proposed Rule 10C-1 under the Exchange Act and certain amendments to Regulation S-K Item 407(e)(3)(iii).

Timing

The comment period for the proposed listing standard and disclosure rules ends on April 29, 2011 and final rules are expected no later than July 16, 2011.

The exchanges must propose listing standards within 90 days, and adopt them within one year, after publication of the SEC's final rules in the Federal Register. Whether the new listing standards will be in place for the 2012 proxy season depends on how quickly the exchanges propose, and how quickly the SEC approves, the listing standards.

The disclosure requirements regarding compensation consultants and their conflicts of interest will be applicable to proxy statements filed in connection with the election of directors in definitive form after the effective date of the SEC rules.²

Applicability

The listing standards will apply only to companies that have listed equity securities (subject to the exemptions discussed below). However, the disclosure amendments regarding compensation consultants and their conflicts of interest will apply to all companies subject to the SEC proxy rules (whether or not listed).

Compensation Committee Independence

Proposed Rule 10C-1(b)(1) requires the exchanges to adopt a listing standard requiring that each member of the compensation committee be (1) a member of the board of directors and (2) independent. The proposed rule also requires the exchanges to develop a standard for determining the independence of compensation committee members.³ The SEC did not mandate any heightened independence criteria for compensation committee members and has instead left the exchanges to develop the standard. The only requirement of the proposed rule is that, in developing the standard, the exchanges must consider the following factors:

- The source of compensation of the director, including any consulting, advisory, or other compensatory fees paid by the company to such director; and
- Whether the director is affiliated with the company, a subsidiary of the company or an affiliate of a subsidiary of the company.

The SEC is seeking comment on whether the exchanges should be required to consider additional factors, including, for example, business or personal relationships between a compensation committee member and an executive officer.

Flexibility Accorded the Exchanges

Proposed Rule 10C-1(b) gives the exchanges greater flexibility to establish independence standards for compensation committee members than they had with respect to independence standards for audit committee members. The Sarbanes-Oxley Act of 2002 and Rule 10A-3 under the Exchange Act expressly prohibit audit committee service by directors that (1) accept direct or indirect compensation or (2) are affiliated persons. Proposed Rule 10C-1(b) does not, in contrast, require the exchanges to adopt a standard that would bar service on a compensation committee for these or other reasons. Instead, the proposed rule only requires that the exchanges "consider relevant factors," including receipt of compensation and affiliate status.⁴ Given this

flexibility, it is possible that the NYSE and Nasdaq may propose independence standards that differ from audit committee standards – and/or differ from each other.

Attached as Annex A is a chart comparing the current heightened audit committee independence requirements under Sarbanes-Oxley with the required factors for stock exchanges to consider in developing standards for compensation committee independence.

Applicability Beyond the Compensation Committee

Under Proposed Rule 10C-1(b), the independence standards adopted by the exchanges will apply not only to the compensation committee, but also to any committee of the board "performing functions typically performed by a compensation committee," even if the committee is not designated as a compensation committee or performs other functions as well.⁵ Note, however, that the listing standard would not be required to apply to a committee that addresses only *director* compensation.

The SEC is seeking comment on whether enhanced independence standards should also apply to directors who perform executive compensation functions in the absence of formal committee membership. Nasdaq does not require a formal compensation committee and permits compensation decisions to be made by independent directors constituting a majority of the board's independent directors in a vote in which only the independent directors participate.⁶

Opportunity to Cure Defects

Proposed Rule 10C-1(a)(3) requires that the listing standards of the exchanges provide an opportunity to cure defects in independence. The standards may permit a compensation committee member to remain on the committee for a period of time after ceasing to be independent for reasons outside his or her reasonable control.

Independence of Consultants and Other Advisers

Neither the Dodd-Frank Act nor the SEC's proposed rules require that compensation consultants, legal counsel or other compensation advisers be independent. However, proposed Rule 10C-1(b)(4) requires the exchanges to develop various factors bearing on the independence of advisers that the compensation committees must consider *prior* to selecting such advisers. These factors must include the following:

- whether the firm employing the adviser is providing any other services to the company;
- the amount of fees received from the firm employing the adviser, as a percentage of that firm's total revenue;
- what policies and procedures have been adopted by the firm employing the adviser designed to prevent conflicts of interest;
- any business or personal relationship of the adviser with a member of the compensation committee; and
- whether the adviser owns any stock of the company.

The exchanges may adopt additional factors.⁷

Authority Over Consultants and Other Advisers

Proposed Rule 10C-1(b)(2) requires the exchanges to adopt a listing standard requiring that compensation committees have direct and express authority to appoint, compensate and oversee the work of their advisers, in their sole discretion. In addition, the proposed rules require that each company must provide appropriate funding for the payment of reasonable compensation to such advisers as determined by the compensation committee.

Listing Standard Exemptions

Controlled companies will be exempt from all listing standards, including compensation committee independence, required by proposed Rule 10C-1. The following categories of issuers will also be specifically exempt from the independence standards: (1) limited partnerships; (2) companies in bankruptcy proceedings; (3) open-end registered management investment companies registered under the Investment Company Act of 1940; and (4) foreign private issuers that provide annual disclosure to shareholders of reasons why they do not have an independent compensation committee. In addition, the exchanges (as they deem appropriate) may exempt certain relationships from the independence standards and may exempt smaller reporting companies from the overall standards.

Amended Disclosure Regarding Consultants and Conflicts

In addition to proposing Rule 10C-1, the SEC proposed amendments to existing disclosure rules concerning fees paid to and services provided by compensation consultants and their conflicts. The proposed amendments are designed to integrate the disclosure requirements of the Dodd-Frank Act with the requirements of Item 407(e)(3)(iii), adopted in December 2009 as part of the SEC's proxy disclosure enhancements. The amendments would apply to all reporting companies subject to the SEC proxy rules (whether or not listed), including controlled companies, when they file proxy (or information) statements relating to the election of directors.⁸

Amendments to Disclosure Trigger

Currently, disclosure under Item 407(e)(3)(iii) is triggered by the existence of "any role" of a compensation consultant "in determining or recommending the amount or form of executive and director compensation." The proposed amendments would modify this trigger to require disclosure of whether the compensation committee has "retained or obtained" the advice of a compensation consultant. An instruction to Item 407(e)(3)(iii) would clarify that a compensation committee (or other committee performing equivalent functions) or management has "obtained the advice" of a compensation consultant if such committee or management requested or received advice from a compensation consultant, regardless of whether there is a formal engagement or a client relationship or any payment of fees to the consultant. In the proposing release, the SEC commented that it believes that the practical effect of this change will be minimal.

Disclosure of Conflicts; Factors to Consider

Under the proposed amendments, once disclosure is required under the new trigger, the scope of the required disclosure will broaden somewhat. The current rules focus on the conflicts that arise when a compensation consultant also receives fees for providing other services to a company, whereas the proposed amendments are more open-ended about conflicts of interest and require companies to disclose "whether the work of the consultant has raised *any* conflict of interest and, if so, the nature of the conflict and how the conflict is being addressed." In order to provide some guidance to companies as to how to assess whether a conflict of interest exists, a proposed instruction provides that companies should consider, among other things, the same five factors identified above for compensation committees to consider prior to selecting advisers.

The proposed rules also broaden the scope of the disclosure required under Item 407(e)(3)(iii) by eliminating the exclusion applicable to compensation consultants that provide only advice on broad-based plans or non-customized benchmark data.

How to Prepare

- **Consider Adopting Adviser Retention Procedures.** Companies should consider establishing specific procedures for the compensation committee to follow when retaining its advisers in order to ensure that, when the standard is adopted, the required independence factors are considered. (Five of these factors are already identified and mandatory under the Dodd-Frank Act.) Companies should also consider obtaining, in engagement letters, representations and agreements from their “independent” compensation consultants addressing the five factors.
- **Consider Changes to Compensation Consultant Disclosures in Annual Proxy Statements.** A company expecting to file its definitive proxy statement for a meeting in connection the election of directors after the effective date of the final SEC rules (expected to be no later than July 16, 2011) should focus on the proposed changes to required disclosures regarding the retention of compensation consultants and conflicts of interest.
- **Review Compensation Committee Composition.** While it is possible that the exchanges' independence standards will not be in place in time for the 2012 proxy season, companies should begin to review the composition of their compensation committees (and those board members or other committees overseeing compensation functions).
 - One issue to be resolved by the exchanges is whether (by analogy to audit committee independence standards) directors who are greater than 10% shareholders or who are executive officers of greater than 10% shareholders, including private equity funds, will no longer be eligible for compensation committee membership. In the proposing release the SEC expressly recognized that directors who are affiliated with significant investors (such as private equity funds) may be highly motivated to rigorously oversee compensation and that such directors' interests are usually aligned with those of shareholders generally. The SEC gave the exchanges the freedom to determine that, even though affiliated directors are not permitted to serve on audit committees under Rule 10A-3, such a blanket prohibition may be inappropriate for compensation committees, and that certain affiliates, such as representatives of significant shareholders, could be permitted to serve.⁹
 - Companies should also review and evaluate the functions of other committees to determine whether the enhanced standards could apply to such directors. The proposing release suggests that only oversight of *executive* compensation is covered,¹⁰ so that a governance committee that is only responsible for setting director compensation policies would not be subject to the heightened independence standards.
 - Nasdaq companies that authorize independent directors to provide oversight of executive officer compensation without being constituted as a compensation committee may wish to consider establishing a compensation committee.
- **Review D&O Questionnaires.** Once the exchanges' independence standards are adopted, review D&O Questionnaires to determine whether any revisions are required to capture information about relevant relationships.
- **Review and Amend Compensation Committee Charters.** Once the exchanges' standards are adopted, compensation committee charters should be amended to reflect: (1) any heightened independence requirements as part of committee membership criteria; (2) the authority of the compensation committee, in its discretion, to appoint, compensate and provide oversight of the work of compensation consultants, independent legal counsel and other advisers, and the obligation of the company to provide reasonable compensation to such advisers; and (3) any established policy governing the independence or retention of advisers.

Endnotes

- 1 SEC Proposing Release, *Listing Standards for Compensation Committees* (Release No. 33-9199, March 30, 2011), available at: <http://www.sec.gov/rules/proposed/2011/33-9199.pdf> (the "Proposing Release").
- 2 The Dodd-Frank Act requires that the disclosure enhancements apply for proxy statements filed in connection with annual meetings held on or after July 21, 2011. However, the SEC stated in the Proposing Release that (regardless of the date of the annual meeting) such disclosures will not be required for proxy or information statements filed in definitive form before the effective date of Rule 10C-1. See Proposing Release at 57.
- 3 The heightened independence standards to be developed by the exchanges will be in addition to the already existing requirement that the board of directors be composed of a majority of directors that qualify as "independent" under the applicable listing standards.
- 4 The Proposing Release states that the "exchanges would not be required to adopt those prohibitions in their definitions and will have flexibility to consider other factors in developing their definitions." See Proposing Release at 16.
- 5 The Proposing Release states that "Congress intended to require that 'board committees that set compensation policy will consist only of directors who are independent.'" See Proposing Release at 7. See also H.R. Rep. No. 111-517, Joint Explanatory Statement of the Committee of Conference, Title IX, Subtitle E "Accountability and Executive Compensation," at 872-873 (Conf. Rep.) (June 29, 2010).
- 6 See Nasdaq Marketplace Rules, Rule 5605(d).
- 7 The factors must be competitively neutral among categories of consultants, legal advisers and other advisers. See Proposing Release at 22. The Proposing Release states that "[a]lthough there is no relevant legislative history, we assume this intended to address the concern expressed by the multi-service compensation consulting firms that the disclosure requirements the Commission adopted last year are not competitively neutral because they do not address conflicts of interest presented by boutique consulting firms that are dependent on the revenues of a small number of clients." See Proposing Release at 22-23.
- 8 It should be noted that Section 10C specifies that the disclosures are to be required in any proxy or consent solicitation material for any annual meeting of shareholders (or special meeting in lieu thereof). By contrast, disclosure under Item 407(e)(3)(iii) is required in proxy or information statements for annual meetings at which *directors are to be elected*. In proposing the rule amendments, the SEC narrowed the scope of the disclosure requirements contemplated by the Dodd-Frank Act, and determined that the applicable disclosures are the most relevant in the context of a meeting at which directors will be elected. See Proposing Release at 48-49. While Section 10C(c)(2) does not require the disclosure rules regarding compensation consultants to be extended to controlled companies, the SEC stated in the Proposing Release that given the similar nature of the disclosure required by Item 407(e)(3)(iii) and Section 10C(c)(2), the common purpose of the requirements, and to avoid any potential confusion, the disclosure requirement should apply to controlled companies. See Proposing Release at 49.
- 9 See Proposing Release at 17.
- 10 See Proposing Release at 9.

If you have any questions on these matters, please do not hesitate to speak to your regular contact at Weil, Gotshal & Manges LLP or to any member of the Firm's Public Company Advisory Group:

Howard B. Dicker	howard.dicker@weil.com	+1 212 310 8858
Catherine T. Dixon	cathy.dixon@weil.com	+1 202 682 7147
Holly J. Gregory	holly.gregory@weil.com	+1 212 310 8038
P.J. Himelfarb	pj.himelfarb@weil.com	+1 202 682 7197
Robert L. Messineo	robert.messineo@weil.com	+1 212 310 8835
Ellen J. Odoner	ellen.odoner@weil.com	+1 212 310 8438

We thank our colleague Lyuba Goltser for her contributions to this Alert.

©2011. All rights reserved. Quotation with attribution is permitted. This publication provides general information and should not be used or taken as legal advice for specific situations which depend on the evaluation of precise factual circumstances. The views expressed in these articles reflect those of the authors and not necessarily the views of Weil, Gotshal & Manges LLP. If you would like to add a colleague to our mailing list or if you need to change or remove your name from our mailing list, please log on to www.weil.com/weil/subscribe.html, or send an email to subscriptions@weil.com.

Annex A

Sarbanes-Oxley / Audit Committee

Dodd-Frank / Compensation Committee

Definition of Audit Committee

Section 3(a)(58) of the Exchange Act defines an “audit committee” as a body established by and amongst the board of directors of an issuer for the purpose of overseeing the accounting and financial reporting processes of the issuer and audits of the financial statements of the issuer; and if no such committee exists with respect to an issuer, the entire board of directors of the issuer.

Definition of Compensation Committee

Neither the Dodd-Frank Act or the Exchange Act define the term “compensation committee.”

Proposed rules do not preclude the exchanges from establishing a definition.

Independence Requirements: Compensation & Affiliate Status

Section 10A(m) expressly provides that (i) receipt of certain compensation and (ii) affiliate status *preclude* independence.

Section 10A(m) prescribes minimum criteria for independence of audit committee members and permits exchanges to adopt more stringent independence criteria.

Affiliated directors must be barred from service on an audit committee.

Independence Considerations: Compensation & Affiliate Status

Section 10C(a) requires that, in establishing standards, the exchanges “consider relevant factors,” including (i) the source of compensation and (ii) affiliate status.

Section 10C gives the exchanges flexibility to establish their own minimum independence criteria for compensation committee members after considering the specified factors.

No required bar.

Opportunity to Cure Defects

Rule 10A-3(a)(3) requires appropriate procedures for a listed issuer to have a reasonable opportunity to cure defects, before the imposition of any listing prohibition.

Rule 10A-3(a)(3) provides that the listing rules may provide that if a member of an audit committee ceases to be independent for reasons outside the member’s reasonable control, that person, with notice by the issuer to the applicable exchange, may remain an audit committee member until the earlier of the next annual shareholders meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.

Opportunity to Cure Defects

Substantially the same. Proposed Rule 10C-1(a)(3) requires appropriate procedures for a listed issuer to have a reasonable opportunity to cure defects, before the imposition of listing prohibition.

Proposed Rule 10C-1(a)(3) provides that the listing rules may provide that if a member of a compensation committee ceases to be independent for reasons outside the member’s reasonable control, that person, with notice by the issuer to the applicable exchange, may remain a compensation committee member until the earlier of the next annual shareholders meeting of the listed issuer or one year from the occurrence of the event that caused the member to be no longer independent.

**Sarbanes-Oxley /
Audit Committee****Authority to Engage Advisers;
Independence of Legal Counsel**

Rule 10A-3(b)(4) provides that the audit committee has the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

The rule permits, but does not require the committee to hire "independent legal counsel."

Definition of Affiliate; Safe Harbor

Rule 10A-3(e)(1) defines "affiliate" as a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, the person specified. The following are deemed to be affiliates: (A) an executive officer of an affiliate; (B) a director who also is an employee of an affiliate; (C) a general partner of an affiliate; and (D) a managing member of an affiliate.

Rule 10A-3(e)(1)(ii)(A) provides a safe harbor where a person will be deemed not to be in control of a specified person if the person: (1) is not the beneficial owner, directly or indirectly, of more than 10% of any class of voting equity securities of the specified person; and (2) is not an executive officer of the specified person.

Funding

Section 10A-3(b)(5) requires appropriate funding, as determined by the audit committee for payment of: (i) compensation to any registered public accounting firm engaged for the purpose of preparing or issuing an audit report or performing other audit, review or attest services for the listed issuer; (ii) compensation to any advisers employed by the audit committee; and (iii) ordinary administrative expenses of the audit committee that are necessary or appropriate in carrying out its duties.

**Dodd-Frank /
Compensation Committee****Authority to Engage Advisers;
Independence of Legal Counsel**

Substantially the same. Proposed Rule 10C-1(b)(2) provides that the compensation committee must have the discretion to retain or obtain the advice of compensation consultants, independent legal counsel or other advisers.

Same.

Definition of Affiliate; Safe Harbor

Rule 10C-1 does not provide for a separate definition of "affiliate."

The SEC determined not to create any safe harbors for particular relationships because the proposed rules do not require that the exchanges prohibit all affiliates from serving on a compensation committee.

Funding

Same for advisers. Proposed Section 10C-1(b)(3) requires appropriate funding, as determined by the compensation committee for payment of reasonable compensation to a compensation consultant, independent legal counsel or any other adviser to the compensation committee.